SONDERHOFF EINSEL

Newsletter (March 2020) | Legal

"Q&A on the Draft Cabinet Order, Ministerial Ordinance and Public Notice of the Amended Foreign Exchange Act Which Restricts Foreign Investment in Japan"

NOTE: This newsletter was prepared based on its Japanese version as of March 27, 2020, and the information contained in this newsletter has been updated in our next newsletter (click here).

The amended Foreign Exchange and Foreign Trade Law (Law No. 60 of 2019) (the "**Amended Act**") passed the Diet on November 22, 2019, was promulgated on November 29, 2019, and will come in effect by May 29, 2020. While the Amended Act imposes upon "foreign investors" (to be explained later) prior filing requirements on the acquisition of shares of Japanese enterprises more extensively than before, the details of the prior filing requirements were left to relevant subordinated regulations (i.e., cabinet orders, ministerial ordinances, and public notices), which have not been clarified. This newsletter discusses in the form of Q&A, the draft Cabinet Order, Ministerial Ordinance and Public Notice which were released on March 14, 2020 ("**Draft**").[1]

Q1: What is the aim of the Amended Act?

A1: Recently, the United States, Europe, and other major countries have been strengthening restrictions on foreign investments which are likely to impair national security. As a response to these movements, Japan recognized that it should also take appropriate steps, and passed the Amended Act. The purpose of the Amended Act is to appropriately monitor the involvement of foreign investors in Japanese companies which are engaged in national security.

Q2: Who is a "Foreign Investor" and what changes will be made to the scope of a "Foreign Investor"?

A2: A foreign investor is defined as (i) a non-resident individual, (ii) a company or other association established under a foreign law, (iii) a company whose 50% or more voting rights are directly or indirectly held by (i) and/or (ii), or (iv) an entity of which a majority of its directors,

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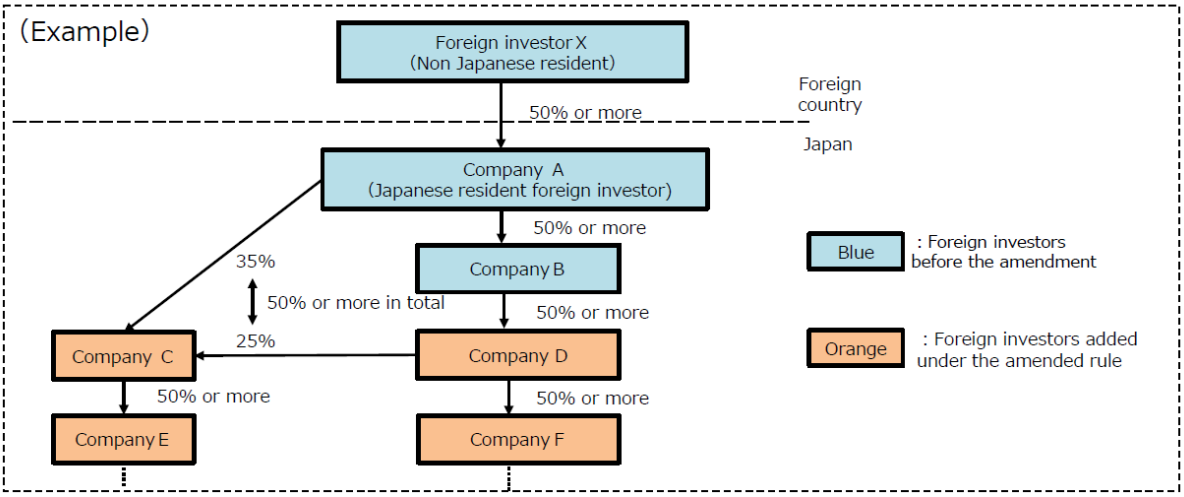
[1]As of March 27, 2020, the draft cabinet order, ministerial ordinance and public notices were subject to public comments (https://search.e-gov.go.jp/servlet/Public?CLASSNAME=PCMMSTDETAIL&id=395122004&Mode=0). The main text of this newsletter refers to the draft cabinet order for partial revision of the cabinet order related to inward direct investment, draft order for partial revision of the order related to inward direct investment, draft public notice of business types determined by the Minister of Finance, draft public notice of business types determined by the Minister of Finance, draft public notice of standards for foreign direct investment pertaining to national security, draft public notice of standards for specified acquisition.

Please note that the English terminologies used in this newsletter may not always be identical to those used in the materials published by the MOF, although we have tried to adopt them as much as possible

executive officers, or other members having power and authority to control the entity are (i). In the past, Japanese companies (a) whose 50% or more voting rights are directly owned by non-residents or foreign corporations, or (b) whose 50% or more voting rights are owned by Japanese companies falling under (a) were regarded as "Foreign Investors".

However, the Draft now adopts the definition of a "subsidiary" as used in the Company Act, and therefore, a Japanese company can be regarded as a Foreign Investor even if the percentage of voting rights held by a foreign company (or its subsidiaries) does not exceed 50% but such Foreign Investor has certain power and authority to control it. Therefore, an affiliate that had not previously fallen under the scope of a Foreign Investor may be considered as a Foreign Investor due to this amendment. See an example chart prepared by the MOF below.[2]



Q3: What are the major revisions to the Amended Act?

A3: The major revisions include (i) expanding the number of industry sectors subject to the prior filing requirement for the acquisition of shares of Japanese companies by Foreign Investors, and (ii) lowering the threshold for the acquisition ratio of listed companies for the filing from ten percent (10%) to one percent (1%). Furthermore, certain Foreign Investors that are deemed to have low national security concerns will be exempted from the filing requirements.

Q4: What has been clarified by the publication of the Draft?

A4: The change in the scope of Foreign Investors (**See A2**); the industry sectors subject to the prior filing (**See A6**); the activities newly added to the subject of prior filing (**See A7**); and the outline of the new exemption rules (**See A10**) have been clarified.

Q5: What changes are made in the acquisition ratio that require prior filing of the acquisition of shares of listed companies by Foreign Investors?

A5: While previously the threshold of the prior filing requirement was ten percent (10%) or more of the total number of outstanding shares, under the Amended Act, it will be one percent (1%) or more of the total number of outstanding shares.

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[2] https://www.mof.go.jp/english/international_policy/fdi/kanrenshiryou_20200325.pdf. Please note that while this chart indicates the case of "50% or more in total", the test of "control" may qualify other affiliates as a "subsidiary" under the Company Act.

Q6: What changes are made to the industry sectors subject to prior filing?

A6: Previously, 155 out of the 1,465 industry sectors classified by the Japanese Standard Industrial Classification were designated as the industry sectors ("**Designated Sectors**") that require prior filing. In this amendment, the Designated Sectors have been divided into "**core industries**" and "**non-core industries**." Core industries include the following 12 industries.

Core industries[3]
● Weapons; ● Aircraft; ● Space; ● Nuclear energy; ● Generic products usable for military purposes; (Note: there are no limitations or exceptions for the above four items) ● Cybersecurity: Cybersecurity-related services and services related to the provision of programs specifically designed for critical infrastructure; ● Electric power: General electric power transmission businesses, general electric power distribution businesses, electric power supply businesses, and electric power generation businesses (limited to those having power plants with a maximum output of 50,000 KW or more); ● Gas: General and specified gas pipeline operators, gas manufacturers, LPG operators (limited to those with storage facilities or core filling stations); ● Telecommunications: Telecommunications carriers (limited to those who provide telecommunication services across multiple municipalities); ● Water supply: Water utility business operators (limited to those with a water supply population of more than 50,000 people), water for water-supply business operators (limited to those with a supply capacity of more than 25,000 cubic meter per day); ● Railway: Railway business operators (designated public organizations under the Act on Response to Armed Attack); and ● Petroleum: Petroleum Refining, Petroleum Stockpiling, Crude Oil and Natural Gas Mining.

Non-core industries[4]
● Industries not listed in the list of core industries but are related to cybersecurity, electric power, gas, telecommunications, water supply, railway, and petroleum ● Heat supply ● Broadcasting ● Passenger transportation ● Biological preparations ● Security services ● Agriculture, forestry and fisheries ● Leather-related ● Air transport ● Maritime transport

The distinction between core and non-core industries is significant in terms of whether prior notification will be exempted under the regular exemption (**See A10**).

[3] Based on materials provided by the MOF.

[4] *Ibid.*

In addition, the MOF plans to prepare a list of companies indicated as being engaged in a core industry (regardless of being in the above list of core or non-core industries), and will publicize the list by the date of the enforcement of the Amended Act. A newspaper article reported that 400 to 500 companies out of approximately 3,800 listed companies would likely fall into the core industry category.[5]

Q7: Are there any activities that have newly become subject to the prior filing requirement?
A7: In addition to the activities that have been already subject to prior filing, the following two have become subject to the prior filing:

(i) Consent to an agenda of a general meeting of shareholders where a Foreign Investor himself/herself (where the Foreign Investor is an individual) or the Foreign Investor's "**Closely-related Person(s)**" (where the Foreign Investor is an entity) (**See A8**) will assume the office of a board member(s); and
(ii) A proposal and consent by a Foreign Investor to an agenda of a general meeting of shareholders which proposes and consents to a transfer or dissolution of a business that falls into one of the designated core industries.

The Draft has provided clarification on the meaning of the underlined language of the Amended Act "to consent to a substantial change in the business purpose of a company, or other item which has a material influence on the management of a company which is to be specified by a cabinet order as having a material influence on the management of a company".

Regarding the proposal for appointment of a board member set forth in (i) above, consent to the agenda is subject to prior filing, even if the agenda is proposed by the company rather than the Foreign Investor himself/herself. On the other hand, for (ii) above, a proposal made by a Foreign Investor will be subject to prior filing, but a proposal made by the company to dissolve or transfer the business in a core industry will not trigger a prior filing.

Please note that even if a Foreign Investor is exempted from the prior filing requirement on share acquisition (**See A10**), such exemption will not apply to the above two actions (i) and (ii).

In addition, the "acquisition of 1% or more of the voting rights of a listed company, etc." (acquisition of a threshold or more based on voting rights rather than on the total number of issued shares), and the "acquisition of business or succession of business by way of corporate split (absorption-type) (*kyushu bunkatsu*) or merger from a resident" have been also added to the subject of the prior filing requirement under the Amended Act.

Q8: What is a "Closely-related Person(s)"?
A8: This is a person who is closely related to a Foreign Investor and where the Foreign Investor proposes at a shareholders meeting for someone to be appointed as a board member, as discussed in **A7.** Where the proposal is made by a Foreign Investor, the Closely-related Person(s) include its directors, officers, employees, and major business/trade partners. Where the proposal is made by another party (including the issuing company), that definition includes its directors and officers.

[5] Nihon Keizai Shimbun, February 21, 2020; Nikkei Asian Review, February 21, 2020

Please note that the same concept of Closely-related Person(s) is used in the context of the appointment of directors and corporate auditors in the standard (**See A11**) as a requirement for the regular exemption at the time of acquisition of shares.

Q9 What changes are made to investment funds?

A9: Previously, with regard to investment funds, if each general partner (GP) or limited partner (LP) was determined to be a Foreign Investor, such GP or LP was obliged to make a filing regardless of its investment ratio in the partnership.

This amendment has changed the framework and has established a new category of Foreign Investors called "**Specified Partnership**". If the investment ratio of Foreign Investors in the partnership is 50% or more, or if the majority of the GPs are Foreign Investors, the relevant fund will be deemed to be a Specified Partnership.

Please note that even if a Specified Partnership has an obligation of prior filing, it may use the exemption it the relevant requirements are met.

Q10 What is the content of the new scheme of exemption of filing?

A10: While the Amended Act expands the scope of actions subject to prior filing and reduces the threshold of shareholding from 10% to 1%, the Act has established a new exemption scheme, where a company or individual would be exempted from the prior filing requirement at the time of acquisition of listed shares where such acquisition would not likely to fall into the category of foreign direct investment related to national security.

The Draft stipulates two types of exemption.

(1) Blanket Exemption

The first one is a "blanket exemption" which is expected to be available for foreign financial institutions (**See A13**). An acquisition of listed shares by foreign financial institutions will be exempt from the prior filing requirement if the institution meet the standard requirements listed in **A11**, regardless of the ratio of shareholding and whether the target company is in a core industry.

(2) Regular Exemption

The second one is a "regular exemption". According to the publication issued by the MOF, this is expected to be available for investors generally, as well as certain certified sovereign wealth funds and public pension funds ("**SWF**"). As to the SWF, the MOF has indicated that it will review the following two conditions, and then execute a memorandum of understanding (the contents of which are not disclosed) with the qualified SWF. The conditions for a regular exemption provided in the Draft are:

(i) The investment scheme of the SWF is aimed purely for economic profit; and

(ii) The decision-making of the SWF is independent from foreign governments.

Regular exemptions will be granted for the acquisition of shares:

(i) in non-core industries, if standard requirements (**See A11**) are met; or

(ii) of less than ten percent (10%) of a company in a core industry, if the additional requirements (**See A11**), in addition to the standard requirements are met. Acquisition of the shares of ten percent or more will not be exempted and be subject to prior filing.

Q11 What are the requirements (i.e., the standard and the additional requirements) for the exemptions?

A11:

(1) Standard Requirements

In both cases of blanket and regular exemptions, the following standard requirements stipulated in the Draft need to be met for exemption from prior filing.[6]

(i) Foreign Investors or their Closely-related Persons(s) shall not assume the offices of director(s) or corporate auditor(s);

(ii) Foreign Investors shall not propose a transfer or dissolution of the business within the scope of a Designated Sector to the general meeting of shareholders; and

(iii) Foreign Investors shall not access undisclosed technical information relating to the business within the scope of the designated industry.[7]

(2) Additional Requirements

As described in **A10**, where a regular exemption is available, acquisition of 1% or more but less than 10% of shares within the scope of the core industry will be exempted from prior filing if the Foreign Investor meets the standard requirements AND the additional requirements. The details of the additional requirements are as follows:

(i) Foreign Investors shall not participate in committees of the company that have the power or authority in important decision-making with regard to businesses belonging to core industries; and

(ii) Foreign Investors shall not submit written proposals to the Board of Directors of the company for businesses belonging to core industries which request a response and/or action from the Board within a specified time limit.

Q12 What types of Foreign Investors are not eligible for exemptions?

A12: Those who have been sanctioned for violation of the Foreign Exchange Act, foreign governments, and state-owned enterprises are not eligible for exemption, and are subject to the prior filing requirement and subject to examination. However, certified SWFs (although state-owned) could obtain a regular exemption as described in **A10** above.

Q13 What are "foreign financial institutions" in Q10?

A13: A foreign financial institution means a person(s) which is engaged in the following items and under the regulation and supervision under the laws and regulations in Japan or a foreign country:

- Type I financial instruments trading business (security houses);
- Banking business;

[6] Items (1) to (3) of Article 2 of the Act on Foreign Exchange and Foreign Trade, which prescribes standards for ensuring that foreign direct investment specified by the Minister of Finance and the minister having jurisdiction over the business does not fall under the category of foreign direct investment pertaining to national security pursuant to Article 27-2(1) of the Act on Foreign Exchange and Foreign Trade.

[7] Undisclosed technical information refers to confidential technology of a business in a core industry.

- Insurance business;
- Investment management business;
- Investment-type trust business;
- Registered Investment Corporations (Corporate-type Investment Trusts); or
- High-speed traders under the Financial Instruments and Exchange Act.

Q14 How is the examination of a filing conducted? How long will it take until the clearance is obtained?

A14: According to the MOF, an examination will be carried out exclusively from the viewpoint of the purpose of this law; i.e., to prevent the leakage of technical information pertaining to national security and the loss of business opportunities. The MOF expects that for the actions which do not pose any issues from the viewpoint of national security, a notice of clearance would be issued within five business days from the filing. Nevertheless, the items of the detailed examination have not yet been defined.

Q15 Will the Draft have an impact on shareholder activists?

A15: In the MOF's "Frequently Asked Questions on Foreign Exchange Law Amendments" on its website[8], the MOF indicates that, "this amendment aims to further promote sound investment while preventing the leakage of technical information and business activities related to national security, etc., and does not aim to block activists… Of course, exercising shareholders' rights and the dialogue with shareholders are welcomed from the viewpoint of enhancing corporate governance, and it does not impose any additional restrictions on the exercise of shareholders' rights and the dialogue with shareholders that are not related to the aim of the amendment of the law" Nevertheless, the requirements and additional requirements stated in **A11** are related to the basic shareholders' rights that activists generally exercise, and thus the Amended Act will have a significant impact on activist activities.

Q16 What are the restrictions on acquiring shares in unlisted companies?

A16: The restrictions applied for the acquisition of listed shares in Designated Sector will also be applied to the acquisition of shares of unlisted companies. In other words, if an unlisted company to which an investment is made carries out a business in a core industry, the prior filing will generally be required. If an unlisted company to which an investment is made carries out a business in a non-core industry, the prior filing will generally be required, but if it meets the requirements of a regular exemption (**See A10**), it will be exempted from the prior filing requirement.

Q17 What is the schedule and timing of the enforcement and implementation of the new law?

A17: The Draft was released on March 14, 2020 with a 30-day public comment solicitation period until April 12, 2020. The materials published by the MOF indicates that the Cabinet will decide to finalize and announce the Cabinet Order and a list of companies engaged in core businesses (**See A6**) in late April, and the Cabinet Order, the Ministerial Ordinances and the Notices are scheduled to be promulgated in between late April and early May, all of which will come into effect on the date of enforcement of the Amended Act. Therefore, the enforcement date is scheduled to be no later than

[8] https://www.mof.go.jp/international_policy/gaitame_kawase/press_release/faq_191025.pdf (Japanese)

May 29, 2020.[9] The rules under the Amended Act will apply to foreign direct investment made on or after the date on which 30 days have elapsed from the date of enforcement.[10] The MOF is considering the introduction of transitional measures to enable companies to make prior filings under the Amended Act after the date of enforcement but before the date of implementation (**See** our next newsletter (*click here*) for updated schedule).

Going Forward

This Amended Act has been prepared within a short period of time between its drafting, establishment, and enforcement, and the changes in the items and information to be stated in the prior filing forms have not yet been clarified. As mentioned above, the list of the companies engaged in a Designated Sector will be later published. If the new rules are implemented as scheduled, there will likely be confusion in the practice of drafting filings, since a number of items are not clear, and thus, a considerable number of filings will need to be made to clarify the appropriate practice of making these filings. For investors and companies that may potentially become Foreign Investors, it will be necessary to quickly understand the outline of the new rules and prepare an internal business flow for foreign exchange law filings, as well as obtain external consultation so that they can quickly respond to the changes of the Amended Act which may impact the acquisition of shares in listed companies, appointment of board members for their portfolio companies, and handling of voting rights in such companies. In addition, Japanese companies falling under the category of a Designated Sector and/or listed on the MOF's company list need to pay close attention to the movement of the Draft so that they can respond timely to inquiries from Foreign Investors preparing to fill in the required items in the filing forms.

(Released on May 11, 2020, based on the Japanese version released on March 27, 2020)

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[9] The Amended Act shall come into effect within six months of the date of promulgation, November 29, 2019.
[10] Article 3 of the Supplementary Provisions of the Amended Act